FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 8 MARCH 2023

Report of the Interim Director - Finance and ICT

Investments Report

1. Purpose

1.1 To review the Fund's asset allocation, investment activity since the last meeting, long term performance analysis and to seek approval for the investment strategy in the light of recommendations from the Interim Director of Finance & ICT and the Fund's independent external adviser.

2. Information and Analysis

2.1 Report of the External Adviser

A copy of Mr Fletcher's report, incorporating his view on the global economic position, factual information for global market returns, the performance of the Fund and his recommendations on investment strategy and asset allocation, is attached as Appendix 2.

2.2 Asset Allocation and Recommendations Table

The Fund's latest asset allocation on 31 January 2023 and the recommendations of the Interim Director of Finance & ICT and Mr Fletcher, in relation to the Fund's strategic asset allocation benchmark (SAAB), are set out on page 3.

The table also shows the recommendations of the Interim Director of Finance & ICT, adjusted to reflect the impact of future investment commitments. These commitments relate to Private Equity, Infrastructure, Multi-Asset Credit and currently total around £270m. Whilst the timing of drawdowns will be lumpy and difficult to predict, the In-house Investment Management Team (IIMT) believes that the majority of these are likely to occur over the next 18 to 36 months.

	Benchmark	Fund Allocation	Fund Allocation	Permitted Range	Benchmark Relative Recommendation		Recommendation (1)		Adjusted for Commitments (2)	Benchmark Sterling Return	Benchmark Sterling Return
	Final (1)	31/10/22	31/1/23	Final (1)	AF 8/3/23	DPF 8/3/23	AF 8/3/23	DPF 8/3/23	DPF 8/3/23	3 Months to 31/12/22	3 Months to 31/1/23
Growth Assets	**55.0%**	**54.9%**	**56.0%**	**+/- 8%**	**(1.0%)**	**(1.1%)**	**54.0%**	**53.9%**	**54.6%**	**n/a**	**n/a**
UK Equities	12.0%	13.2%	14.1%	+/- 4%	+1.0%	-	13.0%	12.0%	12.0%	8.9%	10.4%
Global Equities:	39.0%	36.7%	37.0%	+/- 8%	(2.0%)	(2.0%)	37.0%	37.0%	37.0%	n/a	n/a
North America	-	1.1%	1.0%	-	-	-	-	-	-	(0.5%)	(0.9%)
Japan	5.0%	5.2%	5.4%	+/- 2%	-	-	5.0%	5.0%	5.0%	4.8%	9.1%
Emerging Markets	5.0%	5.1%	5.7%	+/- 2%	-	-	5.0%	5.0%	5.0%	0.8%	13.2%
Global Sustainable	29.0%	25.3%	24.9%	+/- 8%	(2.0%)	(2.0%)	27.0%	27.0%	27.0%	2.5%	4.0%
Private Equity	4.0%	5.0%	4.9%	+/- 2%	-	+0.9%	4.0%	4.9%	5.6%	2.8%	4.2%
Income Assets	**25.0%**	**26.2%**	**25.2%**	**+/- 6%**	**+2.0%**	**+1.2%**	**27.0%**	**26.2%**	**30.1%**	**n/a**	**n/a**
Multi-Asset Credit	6.0%	6.8%	7.0%	+/- 2%	+2.0%	+1.5%	8.0%	7.5%	9.2%	2.7%	3.3%
Infrastructure	10.0%	10.6%	10.6%	+/- 3%	-	+0.6%	10.0%	10.6%	12.8%	1.2%	1.2%
Direct Property (4)	6.0%	6.0%	5.1%	+/- 2%	-	(0.3%)	6.0%	5.7%	5.7%	(11.9%)	(11.9%) (3)
Indirect Property (4)	3.0%	2.8%	2.5%	+/- 2%	-	(0.6%)	3.0%	2.4%	2.4%	(14.1%)	(14.1%) (3)
Protection Assets	**18.0%**	**15.3%**	**15.3%**	**+/- 5%**	**(1.0%)**	**(2.0%)**	**17.0%**	**16.0%**	**16.0%**	**n/a**	**n/a**
Conventional Bonds	6.0%	4.6%	4.8%	+/- 2%	(1.0%)	(1.0%)	5.0%	5.0%	5.0%	1.7%	1.1%
Index-Linked Bonds	6.0%	5.1%	4.8%	+/- 2%	-	(1.0%)	6.0%	5.0%	5.0%	(6.0%)	1.4%
Corporate Bonds	6.0%	5.6%	5.7%	+/- 2%	-	-	6.0%	6.0%	6.0%	5.1%	6.5%
Cash	**2.0%**	**3.6%**	**3.5%**	**0 – 8%**	**-**	**+1.9%**	**2.0%**	**3.9%**	**(0.7%)**	**0.7%**	**n/a**

Investment Assets totaled £5,979m at 31 Jan-22.
(1) Final benchmark effective from 1 January 2022.
(2) Adjusted for investment commitments at 31 Jan-23. Presumes all commitments funded from Cash.
(3) Benchmark Return for the three months to 31 Dec-22.
(4) The maximum permitted range in respect of Property is +/- 3%.

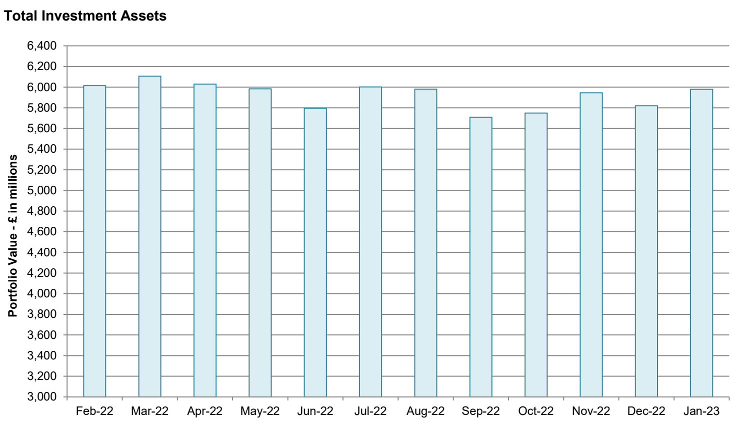
The table above reflects the following three categorisations:

- **Growth Assets**: largely equities plus other volatile higher return assets such as private equity;
- **Income Assets**: assets which are designed to deliver an excess return, but with more stable return patterns than Growth Assets because income represents a large proportion of the total return of these assets; and
- **Protection Assets**: lower risk government or investment grade bonds.

Relative to the final benchmark, the Fund as at 31 January 2023, was overweight Growth Assets (1.0%), Income Assets (0.2%) and Cash (1.5%) and underweight Protection Assets (-2.7%). However, should all the IIMT recommendations set out in this report be implemented, together with the expected level of commitment draw-downs, the cash balance would reduce to -0.7%. In practice as these commitments are drawn-down, they will be partly offset by new net cash inflows from investment income, distributions from existing investments and changes in the wider asset allocation.

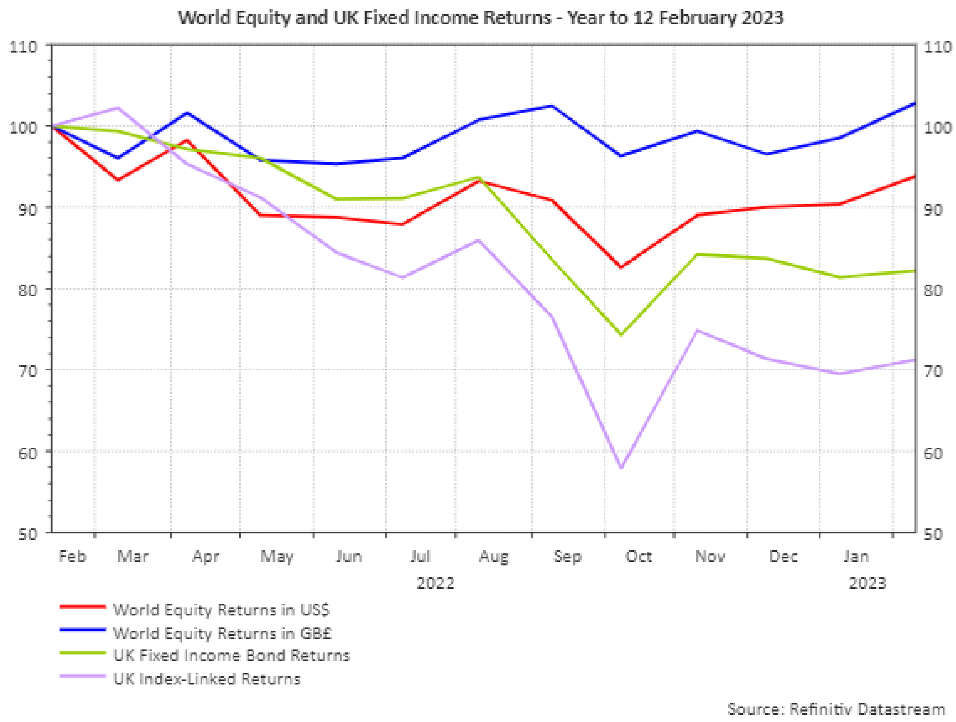
2.3 Total Investment Assets

The value of the Fund's investment assets increased by £230m (+4.0%) between 31 October 2022 and 31 January 2023 to £5.979bn, comprising a non-cash market gain of around £215m and cash inflows from dealing with members and investment income of around £15m. Over the twelve months to 31 January 2023, the value of the Fund's investment assets has fallen £126m (-2.1%), comprising a non-cash market loss of around £186m, partly offset by cash inflows from dealing with members & investment income of around £60m.



The Fund's valuation can fluctuate significantly in the short term, reflecting market conditions, and supports the Fund's strategy of focusing on the long term. A copy of the Fund's valuation on 31 January 2023 is attached at Appendix 3.

2.4 Market returns over the last 12 months



The chart above shows market returns for Global Equities in Sterling and the US dollar, UK Gilts and UK Index Linked bonds for the twelve months to 12 February 2023.

Global Equities have lost around 7% of their value in US dollar terms over the 12-month period, although in Sterling terms Global Equities have returned around +4%. Returns for Sterling investors have been sheltered by a stronger US$ relative to the GB Pound.

The returns from bond markets have also been negative. UK Conventional Gilts have lost around 18% of their value over the 12-month period, whereas UK Inflation-Linked Bonds have fallen almost 29%. Bond yields have risen in 2022 as markets have reacted to higher inflation by pricing higher interest rates rises to reduce inflationary pressures. A bond's price moves inversely to its yield, so this has resulted in lower capital values.

Markets have rallied over the last few months, with the FTSE All World returning 8.7% in GBP terms (17.6% in US$ terms) since the start of October 2022 to 12 February 2023, reflecting month-on-month falls in US inflation.

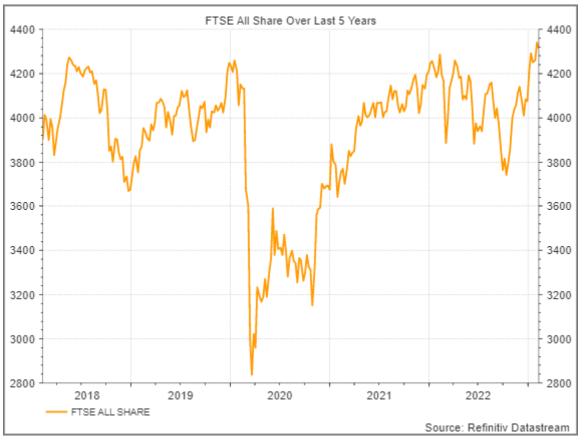
Markets believe that this supports the view that US interest rates have peaked, or are close to, peaking. There is also a growing market view that any global economic slowdown in 2023 will now be shallower than initially feared.

Central banks have remained relatively hawkish over the period. The US Federal Reserve (the US Fed) increased rates by a further 0.5% in December and by 0.25% at the beginning of February, taking the target range to 4.5% - 4.75%, the highest level since October 2007. The Monetary Policy Committee in the UK, increased rates by 0.5% in December and by a further 0.5% in early February, the 10th increase in rates in as many meetings, taking rates to a 14 year high of 4%.

US Fed Chair Jerome Powell said that while recent developments in inflation have been encouraging, substantially more evidence is needed to be confident that inflation is on a sustained downward path. In the UK, the language regarding further rate increases softened slightly, however, risks to inflation were noted to be ‘skewed significantly to the upside’.

Whilst data in both the US and Europe appears to confirm a slowdown in the pace of inflation and has provided support to equity markets, headwinds remain, and there is a risk that markets have got ahead of themselves. The global economic outlook remains uncertain, and it is unclear how the on-going cost of living crises, together with ongoing inflation pressures (whilst inflation may have peaked it remains elevated) and higher interest rates will impact economic activity and corporate earnings. Furthermore, the continuing strength of the US economy, together with a tight US labour market, increases the risk that the US Fed may need to raise rates by more than the market is expecting to bring inflation back to the long-term target level of 2%.

Asset class weightings and recommendations are based on values at the end of January 2023. As shown in the charts below, the UK equity market has now recovered all of the losses resulting from the March 2020 Covid-19 pandemic and the 2022 impact of Russia’s invasion of Ukraine. Equity markets were volatile in 2022, but UK Equities performed strongly relative to other markets, returning 0.3%. The FTSE 100 rose above 8,000 points for the first time on 16 February 2023. In contrast, the US market was one of the worst performing regions in 2022 in local currency terms, declining by 19.1%.



2.5 Longer Term Performance

Figures provided by Portfolio Evaluation Limited show the Fund's performance over 1, 3, 5 and 10 years to 31 December 2022.

Per annum	DPF	Benchmark Index
1 year	(7.6%)	(7.7%)
3 years	3.2%	2.5%
5 years	3.7%	3.3%
10 years	7.4%	6.8%

The Fund outperformed the benchmark over all time periods.

2.6 Category Recommendations

	Benchmark	Fund Allocation	Permitted Range	Recommendation		Benchmark Relative Recommendation	
		31 Jan-23		AF	DPF	AF	DPF
Growth Assets	55.0%	56.0%	± 8%	54.0%	53.9%	(1.0%)	(1.1%)
Income Assets	25.0%	25.2%	± 6%	27.0%	26.2%	+2.0%	+1.2%
Protection Assets	18.0%	15.3%	± 5%	17.0%	16.0%	(1.0%)	(2.0%)
Cash	2.0%	3.5%	0 – 8%	2.0%	3.9%	-	+1.9%

At an overall level, the Fund was overweight Growth Assets, Income Assets and Cash on 31 January 2023, and underweight Protection Assets. As highlighted on page 2, commitments on 31 January 2022 totalled around £270m, potentially increasing Growth Assets by 0.7% and Income Assets by 3.8%. The table on page 4 assumes that these commitments will be funded out of the current cash weighting; in practice as these commitments are drawn-down they are likely to be funded partially out of cash and partially by distributions (income and capital) from existing investments and sales of public market assets.

The IIMT recommendations reflected in this report: reduce Growth Assets by 2.1% to 53.9% (1.1% underweight) (UK Equities -2.1%; North American Equities -1.0%; Japanese Equities –0.4%; Emerging Market Equities –0.7%; and Global Sustainable Equities +2.1%), increase Income Assets by 1.0% to 26.2% (MAC +0.5%; Direct Property +0.6% and Indirect Property -0.1%; increase Protection Assets by 0.7% (Conventional Bonds +0.2%; Index-Linked Bonds +0.2% and Corporate Bonds +0.3%), and increase Cash by 0.4%.

The IIMT notes that the recommendations are subject to market conditions, liquidity, and product availability. The IIMT continues to recommend a defensive cash allocation, albeit lower than the recent norm, reflecting both the general market uncertainty and cash held to fund existing commitment drawdowns.

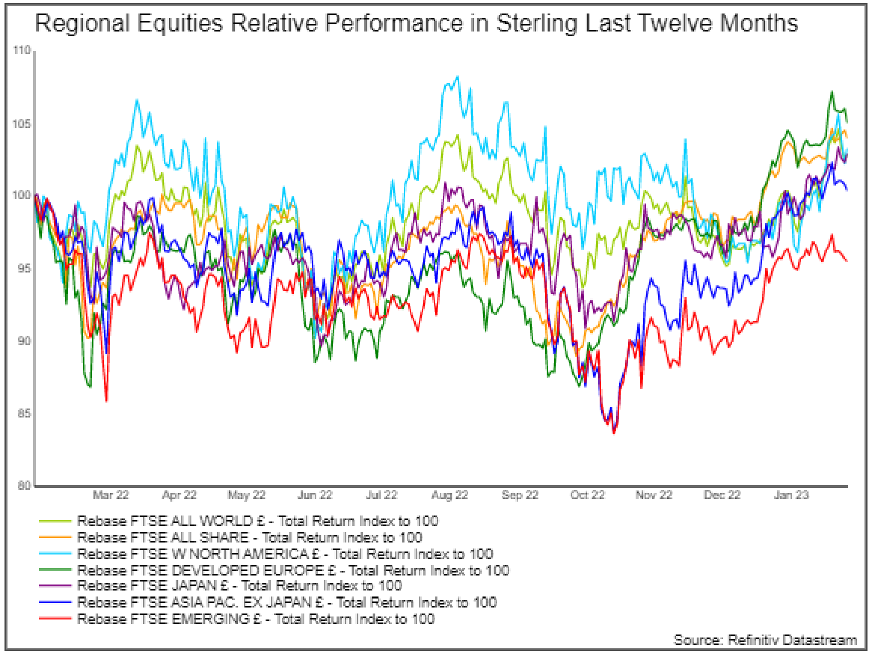
2.7 Growth Assets

On 31 January 2023, the overall Growth Asset weighting was 56.0%, up from 54.9% on 31 October 2022, reflecting relative market strength.

The IIMT recommendations in this report reduce the weighting to 53.9%, 1.1% underweight, albeit flexibility will be required in response to changing economic and market conditions.

While the IIMT remains optimistic about the long term potential for Growth Assets, a cautious stance towards this group of assets is currently recommended due to the headwinds for markets noted above. The IIMT believes that some of the recent outperformance from UK, Japanese and Emerging Markets Equities should be locked in, with a partial switch to Global Sustainable Equities, which should benefit from lower interest rate expectations over the longer-term.

A switch to Global Sustainable Equities from the remaining small allocation to US Equities is also recommended.



Benchmark Return	Currency	Q1-23 (*)	Q4-22	1 Year (**)	3 Year (**)	5 Year (**)	Since Last Committee (*)	L3M 31-Jan-23
Sterling Returns								
FTSE All World	GB£	6.5%	2.1%	(7.3%)	7.9%	8.2%	6.3%	4.0%
FTSE UK	GB£	5.9%	8.9%	0.3%	2.3%	2.9%	5.6%	10.4%
FTSE North America	GB£	6.6%	(0.5%)	(8.8%)	10.8%	11.6%	5.6%	(0.9%)
FTSE Japan	GB£	5.2%	4.8%	(4.8%)	2.7%	2.8%	7.0%	9.1%
FTSE Emerging Markets	GB£	4.5%	0.8%	(6.5%)	1.9%	2.5%	6.0%	13.2%
Local Currency Returns								
FTSE All World	US$	6.9%	10.0%	(17.7%)	4.5%	5.7%	5.5%	11.2%
FTSE UK	GB£	5.9%	8.9%	0.3%	2.3%	2.9%	5.6%	10.4%
FTSE North America	US$	7.0%	7.2%	(19.1%)	7.3%	9.1%	4.5%	6.0%
FTSE Japan	¥	5.1%	3.0%	(3.1%)	6.1%	3.7%	1.8%	2.1%
FTSE Emerging Markets	US$	5.0%	8.6%	(17.0%)	(1.3%)	0.1%	5.0%	21.0%

Source: Performance Evaluation Limited & DPF analysis
(*) To 12 Feb-23
(**) To 31 Dec-22

2.8 United Kingdom Equities

DPF Weightings	
Neutral	12.0%
Actual 31.1.23	14.1%
AF Recommendation	13.0%
IIMT Recommendation	12.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	5.9%
Q3 22/23	8.9%
1 Year to Dec-22	0.3%
3 Years to Dec-22 (pa)	2.3%
5 Years to Dec-22 (pa)	2.9%

The Fund's UK Equity allocation increased from 13.2% on 31 October 2022 to 14.1% on 31 January 2023 (2.1% overweight), reflecting relative market strength.

Mr Fletcher has maintained his UK Equities recommended weight of 13.0%, 1.0% overweight, reflecting Mr Fletcher's assessment of the relative value of UK Equities and Global Sustainable Equities.

The IIMT notes that UK Equities have performed strongly over the last twelve months[1], returning 4.3% in GBP versus -6.7% from North American Equities and -7.4% from the FTSE All World in US$'s. The UK index has a structural bias towards Value stocks, in particular the energy sector, which has benefited from higher energy prices over the last twelve months. The UK index has also benefited from a weak pound and the high level of overseas earnings made by the constituents.

The IIMT believes that it is increasingly likely that interest rates have, or are close to, peaking. This leaves the UK index vulnerably to a Growth rally on a relative basis. As a result, the IIMT recommends that the Fund's current 14.1% overweight allocation to UK Equities is reduced to a neutral allocation of 12.0% to 'lock-in' some of the strong relative performance from UK Equities over the last twelve months.

[1] Year to 12 February 2023

2.9 North American Equities

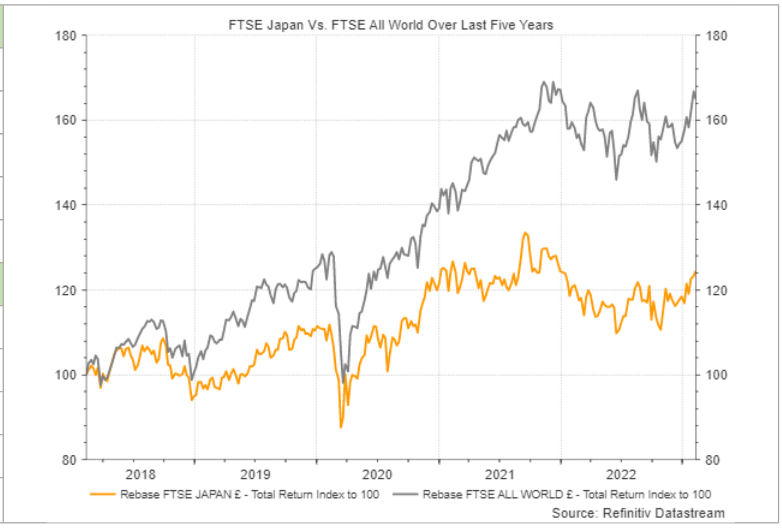
DPF Weightings	
Neutral	-
Actual 31.1.23	1.0%
AF Recommendation	-
IIMT Recommendation	-
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	6.6%
Q3 22/23	(0.5%)
1 Year to Dec-22	(8.8%)
3 Years to Dec-22 (pa)	10.8%
5 Years to Dec-22 (pa)	11.6%

The Fund's North American Equity allocation fell from 1.1% on 31 October 2022 to 1.0% on 31 January 2023 (1.0% overweight), reflecting relative market weakness.

Both Mr Fletcher and the IIMT recommended a zero-weighting to North American Equites in line with benchmark, with the divestment proceeds of around £60m being switched into Global Sustainable Equities. It should be noted that North American Equities account for around 60% of the typical Global Sustainable Equities portfolio.

2.10 Japanese Equities

DPF Weightings	
Neutral	5.0%
Actual 31.1.23	5.4%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	5.2%
Q3 22/23	4.8%
1 Year to Dec-22	(4.8%)
3 Years to Dec-22 (pa)	2.7%
5 Years to Dec-22 (pa)	2.8%



The Fund's allocation to Japanese Equities increased by 0.2% between 31 October 2022 and 31 January 2023 to 5.4%; 0.4% overweight.

Mr Fletcher recommends a neutral weighting relative to the benchmark.

The IIMT continues to believe that Japanese Equities offer sector diversification and defensive qualities. Against a backdrop of global economic uncertainty, Japanese Equities have performed strongly over the last twelve months[2], returning 3.4% in Japanese Yen versus -6.7% from North American Equities and -7.4% from the FTSE All World in US$'s.

The IIMT believes that it is increasingly likely that interest rates have, or are close to, peaking. As a result, some of the Fund's other equity allocations, in particular, Global Sustainable Equities, now offer better relative value, particularly should there be a rally in Growth Assets. The IIMT, therefore, recommends that the Fund's allocation to Japanese Equities is reduced by 0.4% to 5.0% neutral to 'lock-in' some of the strong relative performance from Japanese Equities over the last twelve months.

[2] Year to 12 February 2023

2.11 Emerging Market Equities

DPF Weightings	
Neutral	5.0%
Actual 31.1.23	5.7%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	4.5%
Q3 22/23	0.8%
1 Year to Dec-22	(6.5%)
3 Years to Dec-22 (pa)	1.9%
5 Years to Dec-22 (pa)	2.5%

Relative market strength increased the Fund's allocation to Emerging Market Equities from 5.1% on 31 October 2022 to 5.7% on 31 January 2023 (0.7% overweight), reflecting relative market strength.

Mr Fletcher recommends a neutral allocation of 5.0% to Emerging Market Equities.

In local currency terms, Emerging Market Equities were one of the worst performing regions in 2022, falling by close to 17%. However, performance improved towards the back end of 2022 and the recent 'reopening' of China from Covid-19 lockdowns, which should further ease global supply chains, should provide a boost for the asset class moving forward. As a result, the IIMT continues to believe in the long-term growth potential of Emerging Markets, noting that these markets have accounted for well over half of global growth over the last ten years. However, the IIMT believes emerging market equity returns could be volatile in the short term given the current economic uncertainty, and therefore, recommends a neutral allocation of 5.0%.

2.12 Global Sustainable Equities

DPF Weightings	
Neutral	29.0%
Actual 31.1.23	24.9%
AF Recommendation	27.0%
IIMT Recommendation	27.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	6.1%
Q3 22/23	2.5%
1 Year to Dec-22	(7.1%)
3 Years to Dec-22 (pa)	8.4%
5 Years to Dec-22 (pa)	8.8%

The Fund's allocation to Global Sustainable Equities fell from 25.3% on 31 October 2022 to 24.9% on 31 January 2023 (4.1% underweight) reflecting relative market weakness.

Mr Fletcher recommends a 2.0% underweight allocation of 27.0% to Global Sustainable Equities. Mr Fletcher believes interest rates will continue to rise for some time, increasing pressure on 'growth equity sectors' which are more highly represented in the global sustainable equity strategies.

The IIMT notes that the outlook for Global Sustainable Equities is closely linked to the outlook for inflation and interest rates. Global Sustainable Equities typically favour interest rate sensitive growth stocks and tend to outperform when interest rates are falling and underperform when interest rates are rising. Given the risk that interest rates may increase further moving forward, the IIMT agrees with Mr Fletcher's 2% underweight recommendation, albeit noting that this is 2.1% higher than the actual weighting of 24.9% at 31 January 2023. Reducing the underweight position following a period of relative weakness, will help to position the Fund for any rotation back into growth stocks. The IIMT remains confident about the long-term investment case for the Fund's allocation to Global Sustainable Equities.

2.13 Private Equity

DPF Weighting				
Netural	Actual 31.01.23	Committed 31.01.23	AF Recommendation	IIMT Recommendation
4.0%	4.9%	5.6%	4.0%	4.9%
Benchmark Returns (GB£)				
Q4 22/23 to 12 Feb-23	Q3 22/23	1 Year to Dec-22	3 Years to Dec-22 (pa)	5 Years to Dec-22 (pa)
6.7%	2.8%	(6.1%)	0.7%	2.3%

The Fund’s Private Equity weighting fell by 0.1% between 31 October 2022 and 31 January 2023 to 4.9% (0.9% overweight) reflecting relative market weakness.

Mr Fletcher recommends a neutral weighting of 4.0% in Private Equity.

The IIMT notes that the Fund is 1.6% overweight to Private Equity on a committed basis at 31 January 2023. As a result, the Fund is not considering any further commitments to the asset class at present.

The IIMT recommends maintaining the Private Equity allocation of 4.9% (0.9% overweight) (5.6% on a committed basis).

2.14 Income Assets

On 31 January 2023, the overall weighting in Income Assets was 25.2% (0.2% overweight), 1.0% lower than that reported on 31 October 2022, due to relative market weakness, partly offset by net investment of around £18m. The IIMT recommendations below increase the weighting to 26.2%; 30.1% on a committed basis.

2.15 Multi Asset Credit

DPF Weighting				
Netural	Actual 31.01.23	Committed 31.01.23	AF Recommendation	IIMT Recommendation
6.0%	7.0%	9.2%	8.0%	7.5%
Benchmark Returns (GB£)				
Q4 22/23 to 12 Feb-23	Q3 22/23	1 Year to Dec-22	3 Years to Dec-22 (pa)	5 Years to Dec-22 (pa)
1.8%	2.7%	0.5%	2.7%	3.2%

The Fund’s allocation to Multi-Asset Credit increased from 6.8% on 31 October 2022 to 7.0% on 31 January 2023 (1.0% overweight), principally reflecting net investment of £13m.

Mr Fletcher has maintained his 2.0% overweight allocation of 8.0% to Multi-Asset Credit, funded from a 1.0% underweight allocation to both Global Sustainable Equities and Conventional Bonds. Mr Fletcher notes that whilst spreads have narrowed slightly since the end of Q3-22, the overall yield available, combined with the low duration and floating rate nature of many of the assets, suggests to Mr Fletcher than Multi-Asset Credit remains attractive relative to longer duration assets in a rising interest rate environment.

The IIMT continues to be positive about the long-term attractions of the asset class and favours a strong bias towards defensive forms of credit (e.g. senior secured debt and asset backed securities). The IIMT believes that the current running yield available from the Multi-Asset Class asset class is attractive, and offers value over the longer term, albeit there could be volatility in the short-term. As a result, the IIMT recommends that the current allocation of 7.0% is increased by 0.5% (1.5% overweight); 9.2% on a committed basis.

2.16 Property

DPF Weighting				
Netural	Actual 31.01.23	Committed 31.01.23	AF Recommendation	IIMT Recommendation
9.0%	7.6%	7.6%	9.0%	8.1%
Benchmark Returns (GB£)				
Q4 22/23 to 12 Feb-23	Q3 22/23	1 Year to Dec-22	3 Years to Dec-22 (pa)	5 Years to Dec-22 (pa)
Not available	(11.8%)	(7.2%)	2.3%	2.9%

The Fund's allocation to Property fell by 1.2% to 7.6% on 31 January 2023, reflecting relative market weakness and net divestment of around £8m, principally in respect of Indirect Property funds in unwind. Direct Property accounted for 5.1% (down 0.9%, 0.9% underweight) and Indirect Property accounted for 2.5% (down 0.3%, 0.5% underweight).

Mr Fletcher recommends a neutral overall allocation of 9.0% to property but notes that he would like to see the Direct Property allocation increased in the medium term, funded from realisations out of the Indirect Property allocation. However, Mr Fletcher believes that there may be an opportunity for the Fund to take advantage of distressed selling by other investors by increasing the Fund's exposure to Indirect Property Assets.

The Fund's Direct Property manager notes that because of economic and political upheaval in H2-22, there has been a significant negative re-pricing of UK commercial property. There has been a sharp outward movement in yields resulting in the steepest decline in values since the 2007-08 financial crash. On a more positive note, the manager notes that the correction appears sharp but short, and equity driven investors are now beginning to see this as an opportunity to re-enter the market and acquire good quality assets at prices significantly lower than a year ago.

The total return for all UK commercial property for Q4-22 as measured by the MSCI Quarterly Index was -11.9%, with the capital value fall being -12.8%. The total return for the 12 months to 31 December 2022 was -8.9%, comprising an income return of +4.0% combined with a capital value fall of -12.4%. In comparison, the total return for the Fund's direct property portfolio was -10.7% for the quarter and -6.1% for the 12-month period. The current void rate within the portfolio is 4.6% (last quarter: 5.6%), lower than the benchmark void rate of 8.0%. The portfolio is currently yielding 4.7%.

The Fund's Direct Property Manager continues to focus on assets across all sectors that provide strong core fundamentals in terms of location, quality of tenant and lease length. The property market had a weak finish to 2022 but a more optimistic 2023 appears to be in prospect despite economic recessionary risks.

The IIMT recommends that the Fund's allocation to Direct Property is increased by 0.6% to 5.7% (0.3% underweight) to reflect two properties current under offer and scheduled for completion in Q1-23. The IIMT recommends reducing the Indirect Property weighting by 0.1% to 2.4% (0.6% underweight) to reflect further redemptions from funds in unwind.

The IIMT recommends that further liquidity of up to £60m (1.0%) is made available to the Direct Property manager to make incremental investments at the right time should suitable investment opportunities be identified, funded from matching Indirect Property redemptions.

Notwithstanding the above comments in respect of increasing the Fund's Direct Property allocation from a lower Indirect Property allocation, the IIMT continues to believe that Indirect Property has a role in the Fund's overall portfolio. It increases the options available to the Fund to deploy capital into a relatively illiquid asset class and increases portfolio diversification, including exposure to overseas assets, private rented accommodation, student accommodation, development capital and medical centres.

2.17 Infrastructure

DPF Weighting				
Netural	Actual 31.01.23	Committed 31.01.23	AF Recommendation	IIMT Recommendation
10.0%	10.6%	12.8%	10.0%	10.6%
Benchmark Returns (GB£)				
Q4 22/23 to 12 Feb-23	Q3 22/23	1 Year to Dec-22	3 Years to Dec-22 (pa)	5 Years to Dec-22 (pa)
0.5%	1.2%	3.4%	2.6%	2.7%

The Fund's allocation to Infrastructure remained flat at 10.6% between 31 October 2022 and 31 January 2023 (0.6% overweight), with net investment of £13m (of which £10m related to renewable energy assets) offset by relative market weakness.

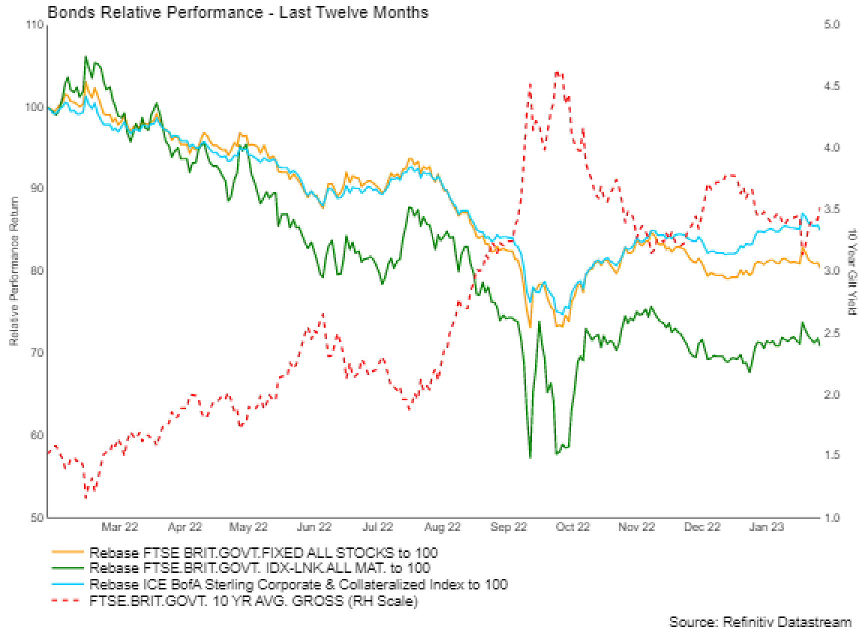
Mr Fletcher recommends a neutral weighting relative to the final benchmark of 10.0% allocation.

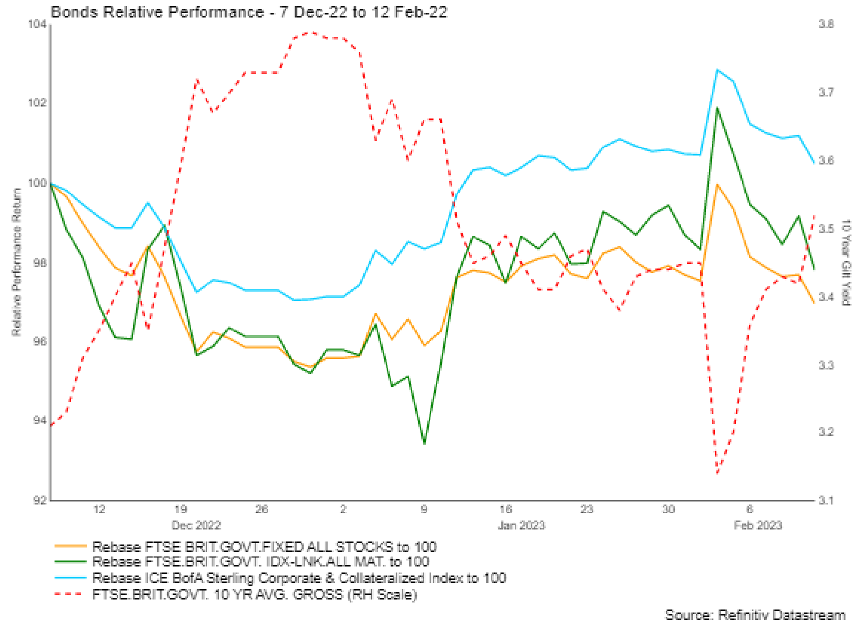
The IIMT continues to view Infrastructure as an attractive long-term asset class and favours a bias towards core infrastructure assets or renewable energy assets. These assets can offer low volatility; low correlation to equity and fixed income markets; and reliable long-term cash flows.

Notwithstanding the noted favourable long-term characteristics of the asset class, the IIMT continues to believe that infrastructure assets are exposed to increased political and regulatory risk, and this risk is best mitigated through asset type and geographical diversification. The current market valuation of some infrastructure assets, particularly renewable infrastructure assets, are becoming increasingly stretched driven by strong investor demand.

The IIMT recommends that the invested weighting is maintained at 10.6% (0.6% overweight); 12.8% on a committed basis. Given the current committed weight of 12.8%, the IIMT is not reviewing new opportunities at the current time.

2.18 Protection Assets



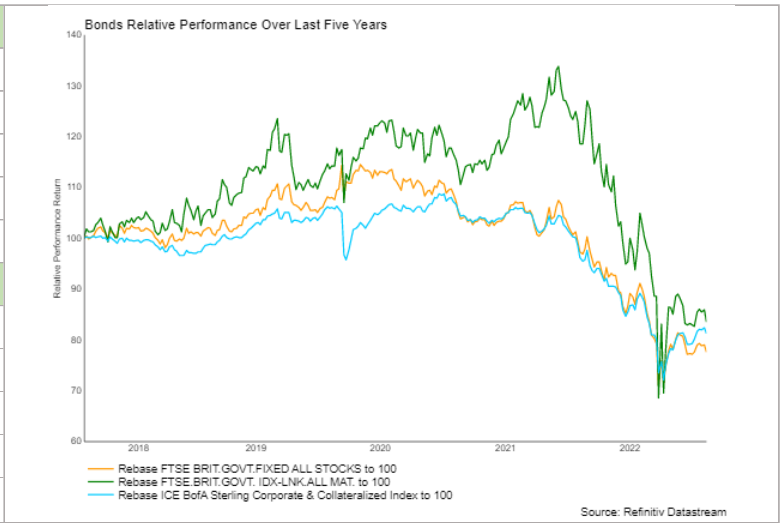


The weighting in Protection Assets on 31 January 2023 was 15.3%, unchanged from 31 October 2022. Net investment of £16m was offset by relative market weakness. The IIMT recommendations below increase the weighting by 0.7% to 16.0%.

Fixed income returns came under increasing pressure in 2022 as bond yields rose (lowering prices), as markets priced in increasing levels of interest rates in both the US and the UK to tackle rising inflation. UK bond yields were extremely volatile in H2-22, particularly in response to the UK Governments ‘mini-budget’ in September 2022. The ‘mini-budget’ was followed by a sharp sell-off in long-dated gilts (pushing up yields), and the BoE was forced into temporary purchases of government bonds to ensure that the market continued to function properly. The UK bond market subsequently stabilised and prices have risen (pushing down yields). UK bond yields fell sharply in early February 2023, after the BoE signalled that the tide may be turning on inflation and that the UK Base Rate may have peaked. However, yields have subsequently increased again reflecting strong US non-farm payrolls, together with better-than-expected Q4-22 UK GDP numbers, which potentially increased the risk of further rate rises moving forward.

2.19 Conventional Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.1.23	4.8%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	1.8%
Q3 22/23	1.7%
1 Year to Dec-22	(23.9%)
3 Years to Dec-22 (pa)	(7.9%)
5 Years to Dec-22 (pa)	(3.4%)



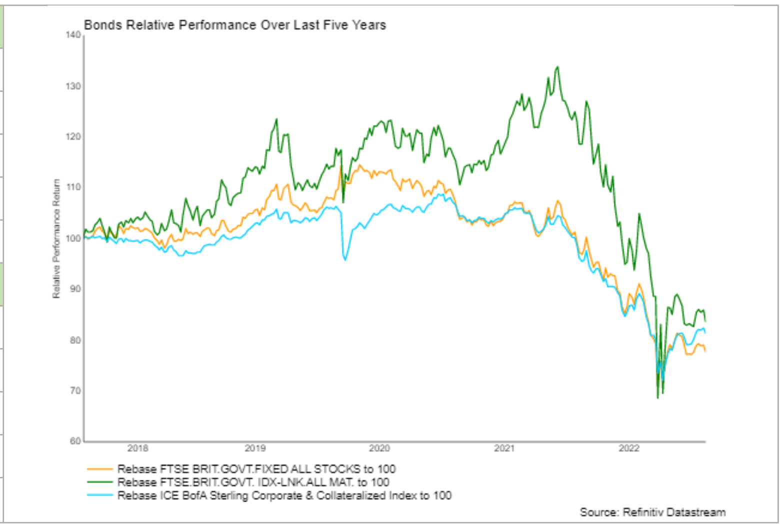
The Fund's allocation to Conventional Bonds increased from 4.6% on 31 October 2022 to 4.8% on 31 January 2023 (1.2% underweight), with net investment of £16m being offset by relative market weakness. The Fund's allocation on 31 January 2023 comprised 85% UK Conventional Gilts and 15% US Treasuries.

Mr Fletcher has maintained his recommended 1.0% underweight allocation to Conventional Bonds. Despite the increase in bond yields in 2022, Mr Fletcher still believes that over the rest of 2023, yields will continue to rise. However, in twelve months' time, slower growth and lower inflation, could mean that bond yields start to fall even if there have been no cuts in interest rates.

The IIMT believes that conventional sovereign bonds offer better value now than they have for some time following the substantial rise in yields over the last twelve months. Sovereign bonds are also diversifying assets which should afford greater protection than other asset classes in periods of market uncertainty, as evidenced by the July fall in bond yields as concerns about the global economy intensified. The IIMT recommends increasing the weighting by 0.2% to 5.0% (1.0% underweight) in line with Mr Fletcher's recommendation.

2.20 Index-Linked Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.1.23	4.8%
AF Recommendation	6.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	2.2%
Q3 22/23	(6.0%)
1 Year to Dec-22	(33.7%)
3 Years to Dec-22 (pa)	(8.4%)
5 Years to Dec-22 (pa)	(4.0%)



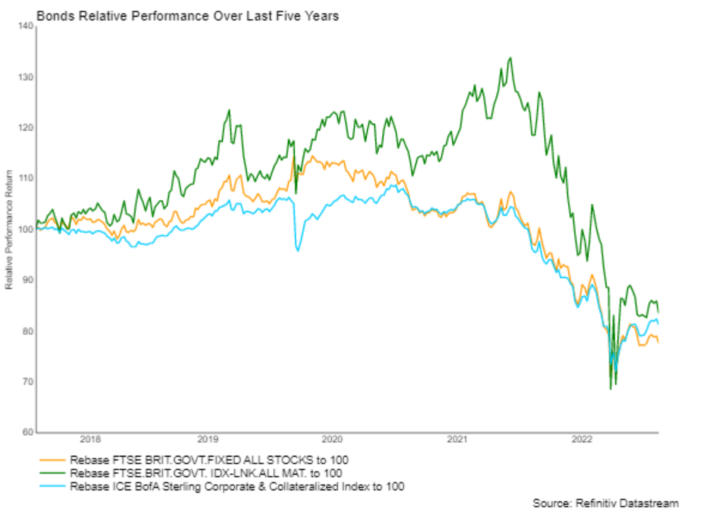
The Fund’s allocation to Index-Linked Bonds fell from 5.1% on 31 October 2022 to 4.8% on 31 January 2023 (1.2% underweight), reflecting relative market weakness. The Fund’s allocation on 31 October 2022 comprised 80% UK Index-Linked Bonds (UK Linkers) and 20% US Treasury Inflation Protected Bonds (US TIPS).

Mr Fletcher has maintained his 6.0% (neutral) allocation to Index-Linked Bonds. Whilst Mr Fletcher still expects yields to rise in the short term, as interest rates are increased, Mr Fletcher believes that Index-Linked Gilts and Corporate Bonds have become more attractive as a medium-term investment.

The IIMT believes that current yields, together with the potential for a longer-term period of elevated inflation, supports a small increase in the Fund’s current allocation to Index-Linked Bonds. As a result, the IIMT recommends increasing the weighting to 5.0%; 1% underweight.

2.21 Corporate Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.1.23	5.7%
AF Recommendation	6.0%
IIMT Recommendation	6.0%
Benchmark Returns (GB£)	
Q4 22/23 to 12 Feb-23	3.0%
Q3 22/23	5.1%
1 Year to Dec-22	(17.3%)
3 Years to Dec-22 (pa) (1)	n/a
5 Years to Dec-22 (pa) (1)	n/a



(1) Benchmark returns for the LGPS Central Limited Investment Grade Bonds Sub-Fund only available since the launch of the product in February 2020

There were no transactions in the period and relative market strength increased the Fund's weighting in Global Investment Grade Bonds from 5.6% on 31 October 2022 to 5.7% on 31 January 2023.

Mr Fletcher has increased his previous 1.0% underweight allocation to Corporate Bonds to 6.0% neutral. Whilst Mr Fletcher still expects yields to rise in the short term, as interest rates are increased, Mr Fletcher believes that Index-Linked Gilts and Corporate Bonds have become more attractive as a medium-term investment.

The IIMT believes that the spread on investment grade bonds is now relatively attractive and investment grade bonds are likely to be more defensively positioned relative to risk-on assets (e.g. equities), should markets experience further periods of weakness. However, the challenging economic backdrop increases the risk of a rise in corporate defaults. The IIMT recommends increasing the Corporate Bonds allocation by 0.3% to 6.0% (neutral).

2.22 Cash

The Cash weighting on 31 January 2023 was 3.5% (1.5% overweight), down from 3.6% on 31 October 2022, principally reflecting net investment across the total portfolio of around £32m over the period.

Mr Fletcher has maintained his recommended weighting in Cash at 2.0% (neutral).

The IIMT notes that global markets are extremely volatile and whilst investor confidence has shown signs of improvement, several significant headwinds remain which could see this reverse, including a slowdown in global activity, continuing inflationary pressures, rising interest rates, energy security concerns, tight global supply chains, the continuing conflict between Russia and Ukraine and the outcome of the US mid-term elections, which could result in political gridlock, with the Democrats controlling the Senate and the Republicans controlling the House of Representatives.

The IIMT recommends a defensive cash allocation of 3.9% (1.9% overweight) due to the uncertain economic and political outlook. This will also ensure that the Fund has sufficient operational headroom after adjusting for term-loan maturities (i.e., short-term loans provided by the Fund to other public sector bodies) to cover upcoming investment commitment drawdowns (expected to be in excess of £100m over the course of the next twelve months).

3. Implications

3.1 Appendix 1 sets out the relevant implications considered in the preparation of the report.

4. Background Papers

4.1 Papers held in the Investment Section.

5. Appendices

5.1 Appendix 1 – Implications.
5.2 Appendix 2 – Report of independent external adviser.
5.3 Appendix 3 – Portfolio Valuation Report at 31 January 2023.

6. Recommendation(s)

That Committee:

a) notes the report of the independent external advisor, Mr Fletcher.
b) notes the asset allocations, total assets and long-term performance analysis set out in the report.

c) approves the IIMT recommendations outlined in the report.

7. Reasons for Recommendation(s)

7.1 Both Mr Fletcher's report and the analysis set out in this report in respect of asset allocation, total assets and long-term performance provide an overview of the Fund's investment strategy and performance track-record on which to assess the asset allocation recommendations for the Fund for the upcoming quarter.

7.2 The rationale for each of the IIMT asset allocation recommendations included in this report is set out in Section 2.

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Appendix 1

<u>Implications</u>

Financial

1.1 None

Legal

2.1 None

Human Resources

3.1 None

Information Technology

4.1 None

Equalities Impact

5.1 None

Corporate objectives and priorities for change

6.1 None

Other (for example, Health and Safety, Environmental, Sustainability, Property and Asset Management, Risk Management and Safeguarding)

7.1 None